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Special bulletin no. 26 (1926, March); Distribution of overhead; Bond discount; Real estate improvements; Certified balance-sheets; Installment furniture business

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DISTRIBUTION OF OVERHEAD

Q. We are desirous of obtaining information regarding the distribution of overhead in the following case:

A company is engaged in manufacturing goods for sale primarily in domestic markets, although it sells a considerable portion of its product abroad. We should like to know what percentage of the total overhead of the company should be allocated to the product manufactured for domestic markets, and what percentage to that manufactured for foreign markets. We should like to ascertain the policy of the larger industrial companies in this respect.

A. The approved practice is to distribute manufacturing department overhead over the whole product evenly, no matter whether for domestic or foreign destination; to distribute general (administrative) overhead in the same manner; and to keep separate any overhead that can be allocated specifically to (a) domestic sales or (b) foreign sales. If there is any other overhead that can not be properly allocated either to foreign or to domestic sales it should be apportioned in proportion to the amount sold.

The general principle is that overhead should not be shifted from domestic to foreign trade or vice versa merely to produce an appearance of consistent profit. It is better to realize fully just what profit is made on each and to be able to estimate the amount that may be sacrificed to keep a foreign trade that is not the primary object of the business but is maintained either to dispose of surplus merchandise or to bring production up to an amount suitable for the size of the plant.

BOND DISCOUNT

Q. A question has arisen regarding the definition or meaning of good accounting practice in dealing with the term "bond discount." The question arises in connection with the computation of invested capital under the federal revenue acts of 1917 and 1918. The facts are as follows:

1. A corporation offers to exchange its interest bearing bonds for the stock of another corporation.
2. At various dates, which extended over a considerable period of time, stockholders of the second corporation exchanged their stock for interest bearing bonds of the first corporation. The offer of exchange dealt only in par values of the stocks and bonds.
3. On or about the dates these exchanges were made, the stock of the second corporation was selling on the New York stock exchange at prices below the face value of the bonds. As stated above, the exchanges

were made over a period of time. The prices on the New York exchange varied from day to day.

4. The bonds were redeemed at par several years before 1917.
5. The second corporation was dissolved and its assets merged with those of the first corporation before 1917.

The treasury department contends that the difference between the market price of the stock of the second corporation and the face value of the bonds of the first corporation should be set up on the books as discount on bonds, and that such amount should be amortized over the life of the bonds. The effect of this ruling is that actual earnings are eliminated from invested capital.

The taxpayer contends that the bonds should be treated as the equivalent of cash; that it obligated itself to pay the face value of the bonds for the stock of the second corporation; that the treasury department can not under the law or the regulations indirectly amortize any part of the purchase price of the stock. Even though it might be admitted that an unwise purchase had been made, the cost of the stock was mostly transferred to goodwill when the second corporation was dissolved so that an attempt is being made to write down the book value of goodwill. As a matter of fact the goodwill is worth several times the par of the bonds issued to acquire it.

Queries:

1. What is bond discount?
2. If the treasury department's position is correct, under what theory of accounting can it be justified?
3. As a matter of accounting procedure how could the accounts be accurately written up, especially as stockholders made exchanges at various times over a period of two years when the market price of the stock and bonds fluctuated from day to day?

Note. The only purpose of the query is to secure a trustworthy definition of the term "bond discount." The tax situation is explained at length in order to show the position of the treasury department.

A. Good accounting practice requires that bond discount should be set up as an asset and amortized over the life of the bonds.

There is a most logical reason for this, which I will endeavor to elucidate as follows:

Bond discount is an expense incurred for the benefit of a corporation and per se for its stockholders. As bonds are issued with the view of deferring the repayment of the capital so obtained to a future date, and during their tenure the shares of stock may change hands, and as the benefit to the corporation of issuing the bonds extends over their life, it would not be correct treatment to charge to the stockholders the total cost of issuance of the obligation at date of issue because the then stockholders would bear a greater portion of the cost than was actually theirs and future stockholders would obtain an unjustifiable advantage.

From Montgomery's "*Auditing Theory and Practice*" is quoted an opinion by the Superior Court of Pennsylvania in the Ben Avon-Ohio Valley Water Company case, in which the court held, among other things, that:

> "While corporations should not be permitted to capitalize their lack of credit, still, where bonds are sold at a reasonable discount and bear a fair rate of interest, such discount should be allowed."

In the case cited, the government's position, the difference between the fair market value of the stock given exchange for the bonds and the par value of the bonds is held to be equivalent to bond discount.

In all the revenue acts the commissioner is authorized to prescribe a system of accounting that will correctly reflect income. True income under good accounting practice would not be reflected by entering the exchange on the basis of par for par because the stock the first corporation received in exchange for its bonds was not fairly worth par, and to show the new stock as an investment at par in the corporation's books would inure to the benefit of the stockholders at date of transaction and the possible detriment of the shareholders of later years.

Good accounting practice provides that books be kept to show cost of assets and expenses. Good accounting practice, however, permits deviations from this practice to account for fluctuations in value over or under cost, as affected by appreciation and depreciation of fixed assets, and in fluctuations in value of stock in trade, investments, etc.

The stock of the second corporation seemed to cost par value to the first corporation, but the financial status of the first corporation would not be accurately reflected by valuing this stock at date of its acquisition at par value.

This loss in the transaction is exactly equivalent to a case where a corporation sells its bonds for cash at less than par value. In the latter case good accounting practice would require the setting up the difference between cash received and the par value of the bonds as a deferred asset to be amortized over the life of the bonds.

The fact that the exchange was effected over a period of time at different prices for the stock does not alter the situation for it follows that the obligation on the bonds did not take effect until they had been sold.

Conclusion:

(1) Bond discount is the price or bonus paid for borrowed money or value.

(2) The treasury's position can be justified by the sections of the several acts that require taxpayers to keep their books in such a manner as will correctly reflect income in accordance with the best accounting practice.

(3) As to accounting procedure in the instant case the accounts could be accurately written up by making entries at dates the actual exchanges were made of bonds for stock, somewhat as follows:

Bond discount	———		
Stock of B Corporation at market value at date of		———	
exchange to bonded debt			———

An expression of opinion is desired as to what is a proper definition of the term "bond discount". The inquirer has expressed the opinion that if stock of one corporation is acquired by another corporation in exchange for the latter's interest bearing bonds, the cost of the stock acquired should be entered on the books of the purchaser at the par value of the bonds and that no bond discount exists in such a transaction.

The inquirer points out, on the other hand, that the treasury department holds that the bonds were issued for the market value of the stock exchanged for them and consequently, the difference between the market value of the stock on the date it was exchanged and the par value of the bonds should be set up as bond discount on the books of the purchaser and amortized over the life of the bonds.

The term bond discount, in the ordinary case, represents the difference between the par value of issued bonds and the actual cash proceeds received by the issuing corporation at the time the bonds were issued. Bond discount represents the additional amount which has to be paid at the time of maturity of bonds issued, over and above the cash or its equivalent received at the time of issue.

The question, therefore, is whether the consideration received upon the issue of the bonds is the market value of the stock exchanged therefor, or whether the stock should be considered as being of a value equal to the par value of the bonds issued in exchange.

We think there can be no doubt that the corporation issuing the bonds received property of a cash value equal to the market value of the stock and, therefore, it would be proper accounting practice to charge the difference between the market value of the stock and the face value of the bonds to bond discount and prorate the same over the life of the bonds.

The real question at issue, as no actual cash passed, is "what are the respective market values of the bonds and stock"? We have assumed that the bonds have no quoted market and that their value would be at the time of issue the same as the stock acquired. If, however, the bonds were actually sold at par or better immediately after their issue, then, in our opinion, it would be proper to charge the par value of the bonds as the cost of the stock and there will be no "bond discount". This would no doubt mean, however, that the individuals exchanging the stock would have made a profit which would be taxable in the year in which it was exchanged; the amount of the profit being the difference between the face value of the bonds and the original cost of the stock or March 1, 1913, value if acquired prior to that date.

We see no insuperable difficulty because the bonds were issued at different times over a period of years and that the stock had different values on different dates of acquiral. The facts as to each transaction are determined at the time and the proper amount could be charged to bond discount. There should be no difficulty in determining the annual write-off of bond discount over the life of the bonds.

We have given consideration to your inquiry and submit the following opinion thereon:

1. Bond discount is the difference between the value received when bonds are issued and the nominal amount that is to be paid to liquidate that liability. Wildman in his "*Principles of Accounting*" describes it as interest collected in advance for the difference between the amount of the principal and its present worth. If the value received is in a form other than cash there may be difficulty in measuring the resultant bond discount. This seems to be the difficulty that prompted the question that you have submitted to us.

2. Discount being interest, collected in advance as stated above, it is an expense chargeable ultimately to surplus. It should be amortized over the period between the date the liability is incurred and the date when it is liquidated. In the interim, the unamortized portion of the discount is a deferred charge. The treasury department therefore rightly holds that bond interest as it is amortized is a deductible expense which reduces invested capital.

3. The inquirer undoubtedly has a record of the dates at which the bonds were issued to acquire the stock and the amounts respectively issued and acquired. There should be no difficulty then in ascertaining the market value of the stock acquired by referring to the stock exchange transactions nearest the dates of exchange. The difference between the market value of the stock acquired and the par value of the bonds issued therefore is the amount of discount.

The inquirer does not state how the transactions were recorded in the books. We assume from the information given and from the fact that the treasury department contends that the discount should now be set up that both the stock acquired and the bonds issued were set up at par. We can readily understand the difficulty which your inquirer has in seeing the import of the treasury department's contention.

This difficulty may possibly be lessened by consideration of the following illustration, for which purpose it is assumed that the stock had a par value of $100, a market value of $75, that bonds of a denomination of $100,000 were offered which the holders of the stock declined to accept, and that the bonds were then sold through a banking house which took them at 75. From the sale of $100,000 par value of the bonds the corporation received in cash $75,000. To retire the bonds the corporation has covenanted to pay $100,000; therefore, the bonds have been sold at a discount of $25,000, which sum must ultimately be charged to surplus, thereby reducing the corporation's invested capital. With the $75,000 in cash received from the sale of the bonds the corporation went into the market and acquired $100,000 par value of the stock at its market value of 75.

The effect of these transactions upon the surplus and invested capital of the corporation is exactly the same as it would be had the $100,000 of bonds been issued directly to the holders of the $100,000 par value of stock.

The inquirer is in error when he contends that the amount paid to retire the bonds determines the value of the stock acquired. Such is not the case as will be seen if it were considered that the corporation had covenanted to retire the bonds at 110. In such a case there would be a futrher deductible expense in the premium paid upon retirement of the bonds, being the amount of cash paid over the nominal value of the bonds.

The cash payments only liquidate the liability. The factor that determines whether or not bond discount enters into the original transaction and the amount of the discount is the value of the consideration received upon the issue of the bonds. Therein appears to be the inquirer's only possible opportunity to avoid the effect of discount upon its invested capital and that is to marshall an array of facts which will show that the price at which the stock was traded on the exchange did not represent the true market value. This will be a difficult proceeding but not necessarily an impossible one. Factors other than the actual condition of the company often influence the trading prices. If such factors existed they should be cited. For example the corporation may have had a good earning power but for reasons satisfactory to itself reinvested its income rather than distribute it in the form of dividends, which would have the effect of lowering the trading price. Another factor which might be cited is the actual value of the assets back of the stock which again is not necessarily a determining factor in fixing the trading price.

The difficulty in dealing with the treasury department on this matter will be that the trading exchange value is generally recognized as a fair and reasonable one and that the burden of proof is upon one who would assert another value.

The transfer of the cost of the stock to the goodwill account does not necessarily render the latter proof against assault by the income tax unit; on the contrary it may support the treasury department's contention that upon the dissolution of the second corporation there remained no asset of a reasonable value that could be set up on the books in place of the value previously carried for the stock. In other words the books of account appear to support the treasury department's contention that the stock when acquired was not worth its par value and that consequently the bonds were issued at a discount and the invested capital has been reduced by the amortized amount of such discount.

Your definite query as to a trustworthy definition of the term bond discount can only be answered, it seems to me, by stating that bond discount represents the difference between the amount realized from the sale of bonds and the face amount of such bonds when they are sold for less than the face amount.

I appreciate the fact that the practical meaning of bond discount as applied to the problem in question is now a matter between the treasury department and your inquirer. No outside opinion is of any value. However, I can not forego saying that I believe the treasury department to be in error in its position for the reason that the quoted market price of any stock does not necessarily represent its real value to a buyer for control. In the case cited it is quite within reason to assume the stock acquired in exchange for bonds was actually worth the face amount of the bonds. If this were true then the fact that bonds were given in exchange for stock would not make the fact measurably different than if cash had been paid therefore.

In order to accept the treasury's position as correct it must be assumed first that the company's credit conditions were such that its bonds could not have been sold at par for cash and stock acquired in exchange for the bonds was not worth the face amount of the bonds issued in payment for same.

Your query as to accounting procedure may be answered by saying that I believe if a bond discount is recognized as proper that no attention should be given to the fluctuations in the market price of the stock during the period in which the exchanges were made. It seems to me that the basis taken should be the market value at the date when the offer to holders of the stock was made.

We submit the following:

1. Bond discount, as the term is generally understood in accounting practice, represents the excess of the face value of the bonds over the cash, or cash equivalent, received by the issuing corporation at the time of their original issuance.

Ordinarily bond discount should be amortized over the life of the bonds, but if any of the bonds are retired before maturity, the unamortized portion of such bond discount as is applicable to the bonds so retired should be charged off to Profit and Loss during the year of their retirement.

2. Referring to the case cited, it appears that the issuing (first) corporation acquired stock of another (second) corporation in payment for its bonds, and that the cash value of said stock, based on representative sales of such stock on the stock exchange, was less than the par value of the bonds. If this be an established fact it seems to us that the difference between the cash value of the stock and the face value of the bonds represents bond discount. However, if any of the bonds were sold for cash about the time of these transactions at a higher value, such transactions may be considered as better evidence of their true cash value at the date of issue than the cash value of the stock, on the assumption that the issuing corporation could have obtained cash for its bonds in this amount had it not exchanged such bonds for the stock of the second corporation.

3. As to the accounting procedure required to accurately record the numerous transactions which occurred at various times, we think that the discount involved in each transaction should be separately determined. Of course, if the cash value of the stock remained constant for a period of time, the discount in all transactions within that period could be determined in one computation. In our practice we have had several engagements in which a series of such transactions was involved, and in each case we found it necessary to actually determine the premium or discount in each day's transactions.

REAL ESTATE IMPROVEMENTS

Q. A real estate company was incorporated to acquire land and thereon to erect and afterwards operate an office building.

The total cost of the land and building was $3,500,000 which included the cost of the tangible property and interest on capital, insurance and taxes during construction, and the sum of about $90,000 being the cost of advertising and a special corps of men who were employed to secure leases for the building so that immediately on its completion the lessees took possession and revenues commenced without any loss or delay.

Queries:

(1) Was it proper to capitalize this $90,000 and leave it as part of the capital cost subject to regular depreciation charges?

(2) Should the $90,000 be included in "deferred charges"—not a part of the capital cost of the building. If so, on what basis should the charge be extinguished?

Saliers in his "*Accountant's Handbook*," page 448, says:

"Construction costs sometimes properly involve capitalization of repairs, because all costs necessary to bring a plant to operating condition represent capital expenditure. Among these are—interest on borrowed money, engineering, supervision, legal expenses, taxes and overhead."

and on page 808:

"Initial capitalization legitimately covers not only cost of tangible assets but also certain intangible elements in form of promotion, engineering and developmental expenses. Frequently these are capitalized in a single account such as organization expenses or deferred expenses. Ultimately, depending on the nature of the items and the policy of the management, these are either written off or are permanently capitalized. Interest during construction is usually permanently capitalized."

A. There is no doubt that such items as interest and taxes accruing during construction of a building are chargeable to the cost of construction. The outstanding example in these cases is the Interstate Commerce Commission which has always approved of this method.

The item mentioned in your letter, namely $90,000 being the cost of advertising and preliminary selling expenses, is, in my opinion, of an entirely different nature. It should not be charged to the cost of building but should be set up as a deferred charge which may be distributed over a period to be determined by the proprietor; I should think, usually three to five years. In the instance you mention, the term would probably be determined by the length of the leases secured through these disbursements.

The matter is open for discussion and I dare say you will find some excellent accountants who may differ from me in the above view but rather wide experience in such matters leads me to think that the plan I have suggested is the one safe course to follow.

A distinction should be drawn between cost of construction and cost of operation and I incline to the opinion that the cost of advertising and soliciting of prospective tenants is an operating and not constructing cost.

In our opinion it is not proper to capitalize the $90,000 as a part of capital cost but that the sum may be included in deferred charges for a short time.

Under the circumstances, we believe that this deferred charge should be extinguished against the earnings of the first year because it seems to represent a proper off-set to income which may have been secured through the early leasing of the premises.

CERTIFIED BALANCE-SHEETS

Q. In making an annual audit for one of my clients who has a small issue of preferred stock which has a retirement provision, this provision being that 10% of the profits, after preferred stock dividends and taxes, is to be set aside in a sinking fund for the retirement of this stock. I placed a qualification on the bottom of the balance-sheet before certifying the same as follows: "Subject to the creation of a sinking fund of 'X' dollars for the retirement of preferred stock," which according to my idea is correct.

My client contends that inasmuch as the balance-sheet which is being certified is as at December 31st, that it is physically impossible to set up this sinking fund before the end of the year. He, therefore, objects to this qualifying statement.

A. There seems to be no particular reason why the qualification referred to should not be omitted. Except for the amount of premium that might be paid for the preferred stock retired the operation would not affect the surplus at all. It is not stated that the provision is to take the form of setting aside actual cash for the purpose of retiring the stock, and even if it did the cash could not be set aside before the profit and amount of retirement fund dependent thereon were determined.

Perhaps the matter could be adjusted by a note, not a qualification, saying that a retirement provision existed; or the preferred stock could be described in the balance-sheet as having a retirement provision.

The objection of the company to a qualification in the certificate after it had done all that it could do at December 31 is not without some force and unless the auditor believed that the omission of the qualification would give such a presentation as to mislead some one to his disadvantage, we think it might well be left out and a note such as suggested above substituted therefore.

INSTALMENT FURNITURE BUSINESS

Q. Some instalment furniture companies are desirous of adopting a reserve system for providing for losses on accounts. We should like to obtain from you data regarding the percentage of sales set aside by companies of this nature, to take care of losses on bad accounts.

We should also like to ascertain the manner in which a reserve of this character should be established, and the character of the items chargeable.

A. This question must be answered in two ways, according to the method of accounting for profits, namely:

(1) where all the profit is taken into income in the period during which the sale is made, and

(2) when the profit is taken into income only as collected, in accordance with the practice which is permitted by the United States treasury department for income tax purposes.

Under the first condition it seems to us that provision for uncollectible accounts should be made periodically (according to the fiscal period), by a charge against income and a credit to reserve of an amount representing a certain percentage of the net sales during the period. Your information to the effect that losses in this kind of business run from seven to ten per cent seems to be about right, but if the particular concern has been in business long enough to determine what its losses may be expected to be, the experienced rate should be used. The charges against the reserve would consist of the amounts of accounts definitely determined to be uncollectible, less any recoveries through repossessions of furniture. The balance of the reserve should be adjusted periodically (say once a year) to accord with conditions as they appear at the time.

Under the second condition mentioned above, only such profit would be taken into income as was realized in cash. If this practice is adopted, it seems to be unnecessary to create any reserve for uncollectible accounts. It will, of course, be necessary to make adjustments of the accounts receivable from time to time to give effect to failure of realization, but such adjustments would not affect the income. It should not be necessary for us to outline the bookkeeping procedure incident to the keeping of accounts upon this basis.

The only figures which we have are of one large furniture instalment house whose losses in the year 1924 averaged about 3½% of their sales and during the year 1923 about 5%.